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Regulators Face Tricky Balancing Act Over Basel III

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WASHINGTON - U.S. regulators are facing a series of difficult choices as they weigh how to finalize Basel III capital and liquidity rules next year.

On one side are international regulators, who are watching to see how closely the U.S. adheres to an international framework agreed to by the industrialized countries of the world. On the other are community bankers and many members of Congress, who are demanding changes to how regulators initially proposed to implement the agreement, which is designed to improve the quality and quantity of capital that banks must hold.

Some observers predict regulators may soon take the Solomon approach, separating the process into two parts, allowing them to move ahead with rules that would strictly apply to the largest banks, while delaying and making significant compromises to a separate set of capital and liquidity guidelines for community banks.

"The goal of the U.S. is to try to finalize the capital rules and also the liquidity rules as quickly as it can to preserve the hoped-for global framework," said Karen Shaw Petrou, managing partner at Federal Financial Analytics. "To do that, they're going to have to separate the community bank stuff that is politically contentious and so difficult to do into a free-standing rulemaking and finalize the quantity and quality capital rules in the first notice of proposed rulemaking and the advanced proposed rules in the third NPR, which is Basel III, as quickly as they can."

Regulators released three proposals in June. The first would establish minimum capital and liquidity requirements for all banks, large and small. The second plan, known as the standardized approach, would fundamentally change risk weightings on assets, which could have a significant impact on a bank's capital ratio. The third proposal, known as the advanced approach, would put into place additional requirements only for the largest banks, such as a leverage ratio and countercyclical buffer.

After receiving more than 2,500 comment letters - mostly from community bankers alarmed by the impact such rules could have on their businesses - the U.S. agencies said they would miss an international Jan. 1 deadline, instead postponing the final rule indefinitely. The U.S. is among 17 other countries that have released proposals, but have not yet finalized them. Only eight countries, including China, India, Japan and Switzerland, have issued final regulations.

Federal Reserve Board Gov. Daniel Tarullo tried to provide assurances to the international community this month that such a delay should not be interpreted as "diminution of commitment to the Basel III package" by the U.S.

"We need to have a democratic process around legislating that means it has to go through our congressional process," Tarullo said. "Here in the U.S. it's complicated by the standardized revision particularly as they affect the smaller banks, and I think in the EU it's just complicated by what is always a somewhat complex machinery for things that affect both nations and the EU as a whole."

Such fracturing has caused some observers to suggest that there could be a breakdown in Basel III, especially as each country implements the package of rules differently.

"We're two years after the Basel Committee issued its framework and you still have some questioning whether the whole thing will come into effect at all," said Greg Lyons, a partner at Debevoise & Plimpton. "I think that's because in part there is not a uniform system that is developing. You just have all these variations occurring across the spectrum and the more varied it becomes, the more constituencies there are, the more difficult it is."

The Basel Committee on Banking Supervision held what some have described as a contentious meeting in December, after which the 27-member participants again pledged to implement the global framework, even if some missed the Jan. 1 deadline. The U.S., along with the European Union, and six other nations, vowed to work toward issuing final rules as early as possible.

"They're holding it together barely, and the ability to issue rules is increasingly difficult and implementing them in any harmonious way is still more uncertain," said Petrou, who wrote a paper earlier this year suggesting that the Basel III accord could be teetering on the edge of a breakdown as the gap between those countries that were pressing ahead and those that were not continued to widen.

But regulators do not have much time left, even though the final Basel III package is not supposed to be implemented until 2019. The package of rules includes several transition dates starting in 2013 to allow all countries and their respective institutions to gradually phase-in pieces of the accord, including when certain capital ratios go into effect.

"It is expected that as remaining jurisdictions finalize their domestic regulations during 2013, they will incorporate all the remaining transitional deadlines in line with the original global agreement, even where they have not been able to meet the Jan.1, 2013 start date," said Stefan Ingves, chairman of the Basel Committee and governor of the Sveriges Riksbank, in a Dec. 14 statement.

Even with such pledges, the U.S. decision to postpone the rules has left several questions, including how the three federal banking agencies will proceed, what kind of potential compromise there might be to satisfy community bankers and how fast they can move.

Community bankers had mostly expected the majority of the Basel III plan would apply to them, including a core requirement that banks hold 7% in common Tier 1 capital. But they did not think regulators would suggest changing the risk-weighting calculation for certain assets such as residential mortgages, foreign sovereign debt and corporate exposure.

"A lot of questions remain on what the next steps are," said Hugh Carney, senior counsel for the American Bankers Association. "I don't think anyone has a good handle on that. The regulators are taking the time and are reviewing the comment letters and are meeting with industry. So where it goes from here I'm not sure, and I'm not sure the regulators know either, frankly."

Regulators have already acknowledged that certain parts of the rule warrant further consideration, such as risk weightings on residential mortgages, a bread-and-butter product for most small banks, as well keeping a filter that affects how much capital banks have to hold against certain instruments.

"It is important to remember that these are proposed rules, not final rules, and we are very interested in feedback on all aspects of these proposals," John Lyons, senior deputy comptroller of bank supervision policy and chief national bank examiner for the Office of the Comptroller of the Currency, told lawmakers at a Senate Banking Committee hearing in November.

Some observers predict regulators will complete the rules that apply to the largest, most internationally active banks very soon while taking at least six months to complete the standardized approach. Regulators may even re-propose the standardized approach after the release of the qualified mortgage rule, which is being written by the Consumer Financial Protection Bureau and is expected to be released next month.

"The Fed, OCC, and FDIC will try to finalize the big-bank portion - the heart of the Basel III framework - as early in 2013 as they can. They'll do a final rule as early as February," Petrou said.

But some analysts have doubts regulators will be able to do so given that all large banks that must adhere to the advanced approach must also comply with a provision in Dodd-Frank, known as the Collins amendment, that sets a general capital standard banks will use to calculate as their floor.

"There's some chance that the agencies would go ahead and finalize the advanced approaches separately, and if they do, I don't think they've got real complex issues there," said Susan Krause Bell, managing director of Promontory Financial Group and a former OCC official. "The only twist they would need to figure out would be what to use as a floor as Sec. 171 requires."

As for community banks, Krause Bell expects regulators to maintain the proposed capital requirements for all banks, but perhaps either provide a simplified version for the denominator or apply a certain cutoff so not all would have to apply the new proposed standards.

"I suspect they will want to keep the new Basel III numerator for all banks. The agencies are very big on predominance of common equity, the deduction of some of the intangibles," she said. "My inclination is that they would work with the proposal and maybe revise the most problematic aspects of the denominator they felt were legitimate concerns and while still meeting their supervisory objectives."

Another piece of the Basel puzzle left unfinished this year is the liquidity coverage ratio, or LCR, which requires firms to hold an additional cushion of liquidity for a 30-day period of economic stress. Global regulators have spent the preponderance of the year negotiating a new ratio, after agreeing its initial approach was too flawed. The difficulty has been defining a highly liquid asset. The sovereign debt crisis in Europe has also not helped matters.

"You can't define a highly liquid asset that will always be liquid," Carney said. "They will be liquid until they're not. I think that's been one of the big problems. The other problem is what can the bank regulators do if a bank drops below the liquidity ratios that doesn't compound a liquidity problem?"

The Basel Committee failed to broker a deal at its meeting this month, but is expected to try again in early January. Still, observers are skeptical just how quickly negotiators will sign off on an agreement.

For now, U.S. banks have been working gradually to close the shortfall in meeting proposed liquidity thresholds. The U.S. banking industry's average LCR was 81% as of the second quarter of this year, an increase from 59% in the fourth quarter of 2010, according to an updated study The Clearing House released this month. In that same period, the industry has also worked to reduce its liquid-asset buffer shortfall by more than $700 billion.

Global regulators must also wrestle with a fundamental review of the trading book, identifying financial institutions whose failure would wreak havoc on a particular country, and an international leverage ratio.